

**RESPONSE TO BERR AND OFGEM'S FURTHER
PROPOSALS FOR MORE FLEXIBLE MARKET
AND LICENSING ARRANGEMENTS**



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DISTRIBUTED ENERGY

RESPONSE TO BERR AND OFGEM'S FURTHER PROPOSALS FOR MORE FLEXIBLE MARKET AND LICENSING ARRANGEMENTS

LONDON CLIMATE CHANGE AGENCY

Executive Summary

1. BERR and Ofgem's proposals are welcomed. They provide for distributed generation to operate within the electricity market system on terms which are designed to conform to the business models of distributed energy, rather than causing many distributed energy providers to by-pass the system by relying upon various exemptions, but at the cost of scale and a stable regulatory framework.
2. Because of the larger scale of planned decentralised energy projects and the possible effects of the judgement of the European Court in the 'Citiworks' case, the proposals now put forward by BERR and Ofgem will be the only regulatory route to market for many decentralised energy schemes.
3. However, for these proposals to promote the growth of decentralised energy and not have the opposite effect of creating a serious barrier to its growth, it is essential that they are implemented effectively and in particular that Ofgem intervene where necessary to achieve that.
4. Distributed energy providers and other suppliers of electricity applying for the new licensed status put forward in the proposals will not have to be party to the complex and risk related industry codes, provided they fall within the criteria for the new licensed status. It is important that those criteria are broad in scope, do not limit scale and are clear.
5. The proposed Supplier Services Agreement between the distributed energy provider and the fully licensed supplier (whereby the supplier provides a 'bridge' between the distributed energy provider's electricity supply activities and the electricity market place) is a pivotal component within the new arrangements. It is fundamental to their success that the supply of these services is competitive and economic. Ofgem should therefore be prepared to regulate their provision if the market fails to deliver them effectively.
6. The 'netting off' of decentralised energy consumption against generation through the supplier services provider using a trading unit in the balancing and settlement system, is fundamental to the decentralised energy business model, so as to achieve a similar result as was proposed by the use of a metering solution ('virtual private networks').

7. The questions asked in the proposal are answered in paragraph 3 below.

Background

The London Climate Change Agency has explained in working group meetings and prior papers the important and growing role of decentralised energy in London and the urban environment generally and the importance of making adjustments to the electricity market system to accommodate the decentralised energy business model.

Much depends upon the proposals now put forward by Ofgem and BERR working satisfactorily, to enable decentralised energy to operate economically within the electricity market system.

As Ofgem and BERR are aware, decentralised energy providers have tended to by-pass engagement with the electricity market system, by making use of the Class Exemption Order to operate on a licence exempt basis. However, this cannot be the practical route forward for decentralised energy. First, on account of the need to maintain the competitive market for electricity, there is limited scope (even if BERR and Ofgem were minded to use it) for increasing the size of decentralised energy schemes that could be covered by the exemptions; and yet the scale of individual decentralised energy schemes and their number is set to increase substantially. Second, the 'Citiworks' case brings into question the extent to which there can be operated within the terms of the Electricity Directive distribution systems which preclude access by competing electricity suppliers. Although the Citiworks case may not be directed at the use of private (unlicensed) wires, the effects of requiring third party access over private systems would place them in an unsatisfactory regulatory position and give rise in some cases to difficult and expensive metering requirements.

The result is that given the acknowledged costs risks and complexities of the electricity market system to many decentralised energy providers, combined with the unavailability of a 'by-pass' route from licensed status to accommodate the increased scale of decentralised energy, the only practical regulatory route for many of them will be that put forward in these proposals.

It is therefore fundamental to the future of decentralised energy that these proposals work effectively. However, their effectiveness depends upon how they are implemented and Ofgem must embark on that with the clear objective of ensuring that the new regulatory solutions for distributed energy work and enable it to take its important place in the climate change agenda.

There are however, two matters of background upon which BERR and Ofgem's views are specifically sought –

a) The 2007 Energy White Paper states –

'We are establishing a new Distributed energy Unit within the DTI to monitor the development of markets for these technologies, to drive the implementation of these

measures and to ensure that any further barriers to DE that may be identified are addressed’.

It would be very useful and promote discussion regarding any remaining barriers affecting the development of DE if the Unit reported on their view of the impact and effectiveness of their proposals.

b) the proposals do not contain any measure regarding how far they will remove the barriers to DE and the likely effect on the growth of DE. We believe Ofgem should address that issue.

This response is divided into three parts –

1. comments upon the proposals contained in BERR / Ofgem’s paper;
2. matters of implementation;
3. response to the specific questions raised in BERR / Ofgem’s paper.

1. The Proposals

The proposals put forward are summarised in the BERR / Ofgem paper as follows –

- ‘switching off’ the requirement to be a party to and comply with the high cost and high competency industry codes, on condition that the DE scheme has appropriate alternative arrangements;
- encouraging the development and provision of alternative arrangements (such as supplier services agreements) from a licensed third party to enable DE schemes and small suppliers to operate on the public network;
- highlighting areas for industry to lead on with respect to cash out reform, to reduce the penalty inherent for intermittent generators and small suppliers; and
- accelerating the introduction of cost reflective network use of system charging to ensure economic development on public networks as an alternative to constructing private wires.

‘Virtual private networks’ (to achieve the ‘netting off’ between generation and consumption by means of new metering arrangements for decentralised energy sites) were discussed by the working party but not included amongst the proposals, on grounds of cost and complexity and because existing market systems could achieve the same effect. That is because the netting off of on-site consumption against generation can be achieved through the use of a trading unit (incorporating both generation and consumption Balancing Mechanism Units) operated by any fully licensed supplier under existing market practice. Because meeting the netting off requirement in this way does not involve any change in existing market systems, it does not appear as part of Ofgem’s

proposals for change. However, the ability to net off consumption against generation is fundamental to the business model for decentralised energy and it is doubtful if many in the decentralised energy industry will be aware of the availability of this option under existing market rules, important though it would be to them under the new proposals. Ofgem may find it of value to explain to the industry how these existing market arrangements are an adequate substitute for the ‘virtual private networks’ proposal as a means of facilitating the netting off requirements of decentralised energy providers.

The proposals also canvass views on the value of increasing the representation and influence of distributed generation on industry panels and code modification arrangements.

a) ‘switching off’ the requirement to comply with industry codes

The following matters deserve comment in respect of this proposal –

i). eligible licensees and the form of licence

This proposal is the principal measure to relieve distributed generators from the costs risks and complexities of the electricity market system which many are ill equipped to handle. The intended mechanism is that Ofgem issue a direction to a licensee applicant ‘switching off’ Standard Licence Condition 11.2, on conditions that will include the applicant having entered into an agreement with a fully licensed electricity supplier, for that supplier to provide various necessary services relating to the market systems. The need for that will exist because the electricity generation and consumption, export and import arising out of the distributed generator’s business will be visible to the market systems and will need to be dealt with in accordance with industry codes to which the distributed generator will not be a party.

The proposal involves re-framing Condition 11.2, so that it operates in the alternative – that is to say either the applicant agrees to comply with the industry codes as a licence condition, or the applicant produces evidence of an agreement, under which a fully licensed supplier will perform the necessary obligations and Ofgem directs that Condition 11.2 will not apply to the applicant.

An alternative mechanism under consideration is for the distributed energy provider applicant to apply to have the Standard Licence Conditions varied in respect of its licence, to remove the requirements of Condition 11.2 completely. However, this is seen as an unnecessarily cumbersome approach.

In principle, any electricity supplier could ask for SLC 11.2 not to apply to them – not just a distributed energy provider. There is no harm seen in this from the point of view of the distributed energy provider or justification for limiting the ‘switch off’ option to only one class of supplier.

However, dealing with the exclusion of code responsibilities simply by ‘switching off’ a particular condition in existing standard licence conditions (as opposed to creating a

new form of licence specific to the requirements of distributed energy providers and smaller suppliers) may not be sustainable in the medium or long term.

There is already one provision in the Standard Licence Conditions which is inappropriate for small generators / suppliers and which Ofgem will in practice have to desist from imposing on them, namely the 'supplier of last resort' provisions in Condition 8.

Another which will need to be addressed is the impact on small DE operators of applying the Renewables Obligation to them.

Over time, there are liable to be other provisions imposed on licensed suppliers (whether inside or outside the terms of the licence) which are not appropriate for distributed generators or decentralised energy providers. Ofgem may then find themselves distinguishing licensees who are 'switched off' from Condition 11.2 to the point where it is necessary in practice to regard them as a different class of licensee.

ii). criteria for eligibility for an Ofgem direction

The criteria by which Ofgem determines whether it grants a direction to 'switch off' Condition 11.2 must be clear and not subject to sudden change. Distributed energy providers will need to plan on the basis that the 'switch off' facility is available to them, provided requirements already known in advance are satisfied. That will include providing evidence of a binding 'Supplier Services Agreement', but should include fewer requirements regarding accreditation and other matters that are only relevant to licensees who are party to the codes.

b) Supplier Services Agreements – the relationship between distributed energy providers and fully licensed suppliers

Any distributed energy provider licensed on the basis of Standard Licence Condition 11.2 being switched off, will require an arrangement with a fully licensed supplier, since there will be industry code requirements regarding the distributed energy provider's generation, consumer consumption, export and import of power which the distributed energy provider will not be required to perform. The relationship between the distributed energy provider and the fully licensed supplier gives rise to a number of issues, namely –

i) the services required

The services required will include the following –

- top-up and standby electricity to meet any shortfalls in production relative to customer demand and to cover plant outages due to failure or maintenance;

- meter registration, data collection and processing;
- settlement of the charges incurred by the fully licensed supplier on account of a licensed decentralised energy scheme or small supplier operating on the public network, such as network use of system charges;
- the management of processes to allow customers of a decentralised energy scheme to change electricity supplier;
- arrangements for the netting off of demand against generation;
- the purchase of electricity export from a decentralised energy site;
- where a decentralised energy provider wishes to transfer electricity between different sites operated by it, the facilitation of the carriage of that electricity across the public network.

For reasons already explained in this paragraph, it is incorrect to regard netting off services as optional. Netting off of generation against consumer demand is central to the decentralised energy business model and the decentralised energy provider will be dependent upon the services supplier for the provision of that service.

ii). *the capacity in which the services will be provided*

BERR / Ofgem state in their proposal –

‘A key issue to consider is whether customers ultimately belong to the DE supplier or the licensed third party. This will be important in the event of a breakdown of the relationship between the licensed third party and the DE supplier’.

The customers should remain the customers of the DE supplier. Those customers are one of the DE supplier’s principal business assets and should not be in the ownership of any other party.

It is recognised that there are circumstances in which the customers will need to be regarded as customers of the fully licensed services provider – for example interface with the Master Registration Agreement. Under such circumstances it would appear that the fully licensed supplier is holding and dealing in the consumption of and supply to such customers as trustee of the distributed energy provider to whom they belong.

There will be no agency relationship between the distributed energy provider and the fully licensed supplier in respect of functions under the market codes. That is because the distributed energy provider is not a party to those codes and there are therefore no obligations placed on the distributed energy provider for which the fully licensed supplier can or need be its agent.

iii) default by the appointed service provider

If the appointed service provider defaults and the Supplier Services Agreement is terminated or repudiated, then the distributed energy provider will be in breach of its licence, in failing to have a Supplier Services Agreement which can secure performance of the code obligations arising out of the distributed energy provider's licensed business.

The remedy would be to include in the Standard Licence Conditions for supply a condition whereby Ofgem can at short notice secure a 'supplier services provider of last resort', analogous to the current powers of appointment in relation to electricity suppliers of last resort.

A distributed energy provider would not lose its customers as a result of the supplier services provider's default, since the customers should have remained within its ownership. It would however be in default under its licence, unless a replacement supplier services provider was put in place immediately.

iv) form of supplier services agreement

Since both distributed energy providers and fully licensed suppliers will have no experience of supplier services agreements, a working group to determine a framework and what important terms should be included, would be of considerable value. The effect of the output of such a working group would be to promote understanding of what services are needed and how they can in principle be incorporated within a commercial arrangement. This should substantially shorten the period needed to see the provision of supplier services up and running..

Procuring the output of such a working group is a material part of the implementation measures necessary to make these proposals work effectively (see Para. 2 'Implementation' below). The LCCA ask to be included within any such working group.

c) cash out reform

Distributed energy providers have a strong indirect interest in cash out reform, since the cost of small supplier / generator imbalance to any consolidator is significantly influenced by how the cash out arrangements are structured. Ofgem's Cash-out Review, taking into account the impact of the cash out mechanism on smaller suppliers and generators, is therefore welcomed.

However, the impact of the cash out mechanism under the Balancing and Settlement Code upon distributed energy providers is strongly influenced by how licensed suppliers and specialist consolidators price the consolidation services they provide. This will remain an important issue in the context of ensuring that the supplier services arrangements discussed above are competitive.

Although the modification procedures under the Balancing and Settlement Code cause Ofgem's role to be largely reactive, there are important policy issues attached to cash out reform that must cause Ofgem to have as close an engagement as possible with it. The reality is that the NETA / BETTA structure was set up against the probability if not expectation, that it would assist the process of consolidation of supplier and generator interests in the electricity market. Smaller players who, apart from being the principal candidates for producing decentralised energy, also form a source of competition to the six large suppliers, need a cash out mechanism which represents a more reasonable balance between what is manageable by a large, well resourced supplier and what is manageable by a small DE operator, without paying significant fees in consolidation services.

Reducing 'pollution' of cash out prices may help; but Ofgem needs to consider how far a more radical approach is necessary that is more specifically designed to re-balance the market system as between smaller and larger players.

d) cost reflective network use of system charging

Ofgem's initiative in asking the Distribution Network Operators to come forward with proposals for charging methodologies that reflect the cost savings associated with the local production and consumption of distributed energy is welcomed.

Although the subject of a separate review, the changes to the duos charging methodology are an important part of the changes needed to ensure that the market and infrastructure charging systems are adjusted to reflect the cost saving potential of distributed generation and its economic strengths. It is hoped that Ofgem's proposal to place a formal licence condition on Distribution Network Operators to deliver appropriate charging methodologies will give the process more urgency.

e) the participation of distributed energy in the BSC change process

The appointment of a distributed energy representative to the Balancing and Settlement Code panel would be disproportionate for the reasons stated in the proposal.

The question raised is whether the Authority should designate a third party stakeholder to raise modifications to the Code.

In principle this may be a useful step forward, but there are barriers. The first is financial. If the designated party were to be sufficiently informed to raise modifications, there would be significant time and expertise involved and with that money. Second, there remains the perception and reality of the electricity market system being mainly a forum for large players. The ability of a designated distributed energy stakeholder to raise modifications may be seen as of diminished value, because of the comparatively greater time and resource available to the large suppliers and generators who may not share the interests of distributed energy on issues raised in modification proposals and are perceived to be a dominant influence.

A useful step that Ofgem could take would be to include in its assessment of all proposed modifications an analysis of their effect upon decentralised energy generation and supply.

3. Implementation

Some of the proposals contained in BERR / Ofgem's paper are the subject of other reviews, notably Ofgem's Cash – out Review, the re-framing of distribution use of systems charges and connection costs.

Any issues of implementation relating to those proposals are best dealt with in the context of those reviews.

There are however some implementation issues that lie within the areas of the proposed switch off of Condition 11.2 and the implementation of the supplier services arrangements –

a) market complexity and information barriers

It is doubtful whether guidance on the commercial aspects of setting up decentralised energy schemes would be a useful expenditure of resource. Although a specialised area, all potential DE operators have access to specialist advice, usually beginning with engineering and economic studies on the feasibility of the scheme under consideration.

However, there is considerable scope for guidance on the interface with the electricity market mechanisms and the regulatory framework. The need for guidance may apply in particular to the conditions under which an applicant may expect to be able to apply for a direction switching off Condition 11.2 ; to the costs and liabilities they may expect in respect of use of systems and connection charges, together with guidance on supplier services arrangements. Sources of guidance in those areas are likely to be scarce and not necessarily owned by the advisors assessing the feasibility of DE projects from an engineering, economic or legal standpoint.

Guidance on the 'netting off' arrangements is likely to be of particular importance.

b) supplier services agreements

The effectiveness of supplier services agreements in providing the required interface between distributed energy providers and the market system at an economic cost is pivotal to the proposals as a whole.

Without a cost effective relationship between distributed energy provider and fully licensed electricity supplier with regard to the delivery of supplier services, the proposals will not form an effective route to market.

It is suggested that the following implementation measures should be put in hand or planned for –

i) forms of agreement

Reference is made above to the value of establishing a working group to create a framework for supplier services agreements. Decentralised energy providers in particular may benefit substantially from guidance notes on the purpose and content of the agreement and how it fits in with their licensing obligations.

ii) monitoring and enforcement of competitive terms

The proposal states - ‘we welcome stakeholders’ feedback and input on whether it is preferable to let the market develop as DE schemes come forward or whether other measures are necessary to provide more certainty that the services will be available’.

‘In any case, we envisage monitoring developments in the market and reviewing the position in two years time to ensure the market is responding adequately’.

As already stated, the reality is that the effectiveness of the proposals depends upon the competitive and economic supply of the supplier services. We entirely support therefore the proposal to monitor the market for a period of two years in respect of this issue, bearing in mind in particular that established electricity suppliers may lack incentive to provide services which support potential competitors.

We ask however that Ofgem report to BERR after one year on how the supplier services arrangements and the implementation of the proposals generally are proceeding.

If supplier services are not provided on an economic and effective basis however, Ofgem will need to intervene to secure their provision, either by procuring the appointment of a ‘market agent’ to provide the services, or by requiring existing suppliers to provide them as a licence obligation. Whichever option is adopted, it will necessarily need to be accompanied by a degree of regulation on price and terms of delivery, because it will have been failure in those areas that is likely to have been the cause of the need for Ofgem to take action.

Ofgem’s statement contained in para. 5.46 is therefore welcomed –

‘However, we remain open to the possibility that other incentives or possibly even regulation could be needed to ensure these services come forward’.

It is not consistent with that intention and the need to ensure economic and competitive delivery of the services, for the proposals also to state (para 5.52)-

‘It is not intended that Ofgem would regulate the prices at which these agreements are offered or approve these arrangements’.

If Ofgem is to address the delivery of supplier services with the tenacity which it justifies, Ofgem should accept that it may come to that.

3. Response to Questions in the Proposal

Q.1 We welcome views on whether the Authority should exercise its power as provided for under the BSC to designate a third party representative to raise BSC modifications

This could in principle be a useful step forward but there are financial barriers, in that the party designated would need to be resourced to perform the designated role. Also, the electricity market system is dominated by large players who are well resourced and who may not always share the interests of distributed energy on issues raised in modification proposals.

Q.2 Expressions of interest from stakeholders interested in having the power to raise modifications.

No comment

Q. 3 In terms of the length of designation, we believe that a period in line with the Panel's term (eg. 2 years) may be a suitable period with which to trial this proposal. We would welcome stakeholders' views on the period for which designation might last.

2 years would appear to be a suitable trial period.

Q.4 We would welcome views on whether the designated party should be obliged to contribute fees to Elexon in order to participate in the BSC change process. If so, how should the level of contribution be determined?

Logically, a distributed energy designated party should contribute fees to Elexon on the same basis as any other participant. However, see response to Q. 1. There are financial barriers to a designated party playing a useful role and Elexon fees simply raise them. The fees perhaps could be set at a lower or nominal level, to reflect the distributed energy designated party's more limited interest and role in the BSC modification processes, as opposed to large suppliers and generators.

Q.5 Should any other codes be examined in relation to lack of DE representation?

Whether any other codes should be examined in relation to DE representation depends mainly upon whether their terms and methods of implementation give rise to issues of cost, in the context of the provision of supplier services required in connection with these proposals. An example might be costs and expenses arising under the Master Registration Agreement in respect of registration / data provision requirements of DE consumers' meters, the management of which is undertaken by a fully licensed supplier under these proposals.

This question should therefore be kept under review as the implementation of these proposals gets under way.

Q.6 We invite stakeholders to identify any good quality information currently available that would be suitable for including in the development of a user friendly information hub on the process of setting up and operating a DE scheme.

Noted

Q. 7 Do you agree with the proposed licence amendment to SLC 11.2?

We agree with the proposed amendment, but would point out that DE providers will require very clear guidance about the circumstances under which the direction will be granted, so that they can plan their businesses on the basis of a direction being available (see para. 1.a. i and ii above).

Q.8 Should Ofgem issue guidance on eligibility criteria for switching off the code compliance licence condition? If so, what should the main criteria be?

Ofgem should issue guidance on eligibility criteria. (see para. 1.a.ii above). These criteria should include the following –

- require the DE licensee to have an effective Supplier Services Agreement in place, covering the services specified in the guidance
- not involve the DE applicant in eligibility criteria that are only applicable to functions to be carried out by the supplier services contractor (eg accreditation matters applicable to joining the codes)
- in principle applicable to any electricity supply business and not limiting the scope or scale of the business of the DE licensee applying for the direction.

Q.9 Should Ofgem establish an industry working group to develop a good practice guide on supplier services agreements?

Ofgem should do so (see para. 1.b.iv above). This will speed up the availability of supplier services on understood terms and help give the industry confidence.

Q. 10 how should the risks of a breakdown in the DE – Agent relationship be mitigated?

Issues around the default of the appointed service provider are discussed in para. 1.b.ii. above. The risks associated with that are greatly reduced from the stand point of the consumer if Ofgem leaves itself with the power under the terms of the SLCs for electricity supply to appoint a supplier services provider of last resort. That could be under much the same conditions as currently apply to the appointment of a supplier of last resort under Condition 8 of the current SLCs for electricity supply. In the event of a default of the DE provider on the terms of its supplier services agreement leading to its termination, the DE provider will be in breach of its licence. In the event of Ofgem then suspending or revoking it, the current supplier of last resort provisions would appear to be applicable.

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